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IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC., *et al.*,

Petitioners,

v.

MICHAEL BROUDO, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF *AMICI CURIAE* THE SECURITIES INDUSTRY ASSOCIATION AND THE BOND MARKET ASSOCIATION IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICI CURIAE* [1]

The Securities Industry Association ("SIA"), established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Bankers' Association, represents the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. (More information about SIA is available at www.sia.com.)

The Bond Market Association ("TBMA") represents approximately 200 securities firms and banks that underwrite, trade and sell fixed-income securities in the United States and in international markets. TBMA's members transact business in a wide variety of public and private fixed-income securities. Its membership comprises a diverse mix of securities firms and banks, including large, multi-product firms and companies with special market niches. It includes all primary dealers in U.S. government securities, as recognized by the Federal Reserve Bank of New York, and all major dealers in federal agency securities, mortgage-backed and asset-backed securities, corporate bonds, money market instruments, and funding instruments such as repurchase and securities lending agreements. From its inception in 1976,

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[1] Pursuant to this Court's Rule 37.6, *amici* SIA and TBMA state that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amici* and their members made a monetary contribution to the preparation or submission of the brief.

Pursuant to Rule 37.3, *amici* state that petitioners and respondents have consented to the filing of this brief. Petitioners' and respondents' letters of consent have been filed with the Clerk of the Court.

TBMA has worked with its member firms, Congress, the SEC, the Federal Reserve Board and the Federal Reserve Bank of New York, state regulators, and self-regulatory organizations to foster effective, efficient regulation; to enhance the liquidity and efficiency of the fixed income markets; to encourage sound credit and business practices for participants in such markets; and to promote the highest levels of professional standards and conduct in such markets. (More information about TBMA is available at www.bondmarkets.com.)

The issue raised by this case—the proper test for establishing loss causation in securities fraud cases—is one of great import to the securities industry and its investors. It is critically important to SIA and TBMA that member firms not be turned into guarantors that investments will be profitable where there is no causal connection between an alleged misrepresentation and a security's decline in price. *Amici* therefore have a vital interest in the issue presented in this case, and their views can assist the Court in resolving that issue.

INTRODUCTION

This case presents the question whether a plaintiff bringing a civil claim under section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and SEC Rule 10b-5 need only allege and show that he paid an inflated price for the security because of a misrepresentation, or must also allege and show that revelation of the misrepresentation caused a decline in price. Most courts that have addressed the question have adopted the latter rule, requiring a securities plaintiff to satisfy the element of loss causation by showing that the price of the security promptly declined when the allegedly concealed information was disclosed and limiting damages to

the amount of the decline.[2] But in the ruling below, the Ninth Circuit adopted the purchase-time inflation rule, requiring a plaintiff to plead and prove only that the price of a security was "inflated" when he bought shares.[3]

An illustration will demonstrate the vastly different outcomes under the conflicting approaches. Suppose plaintiff P buys $200 of stock in defendant D. As time passes, the value of P's investment declines to $20. *After* this decline, D announces the restatement of an accounting item. After this announcement, the value of P's shares remains at $20. P brings a lawsuit under Rule 10b-5. In the circuits applying the price-decline rule, the case is dismissed on a Rule 12(b)(6) motion because revelation of the alleged misrepresentation did not affect the market price. In contrast, under the Ninth Circuit's rule, P's lawyers bring a class action and hire an expert who opines on how much of the price P paid was "inflated" during the class period because of the undisclosed accounting issue. The case likely results in discovery, probably settlement, perhaps trial, and the prospect of a substantial award to P and P's lawyers—even though no causal link was ever established between any price decline and the alleged misrepresentation.

For the reasons set out below, the Ninth Circuit's rule of loss causation will create the wrong incentives for market participants and litigants, will expose securities issuers and market professionals to potentially devastating liability, and consequently will work substantial harm to the securities

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[2] *See Emergent Capital Inv. Mgmt., LLC* v. *Stonepath Group, Inc.*, 343 F.3d 189, 198-99 (2d Cir. 2003); *Semerenko* v. *Cendant Corp.*, 223 F.3d 165, 184-85 (3d Cir. 2000); *Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 684-85 (7th Cir. 1990); *First Interstate Bank of Nev., N.A.* v. *Chapman & Cutler*, 837 F.2d 775, 779-80 (7th Cir. 1988); *Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441, 1447-49 (11th Cir. 1997).

[3] The Eighth Circuit follows the same rule. *See, e.g., Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

markets and to the economy. By contrast, the majority rule applied in most other circuits accords with the language of the Exchange Act and with long-established federal policy, and will provide the correct incentives for investors and other market participants.

SUMMARY OF ARGUMENT

The loss causation rule adopted by the Ninth Circuit is wrong and should be rejected for three related reasons.

First, contrary to an argument frequently made by securities plaintiffs, the Ninth Circuit's loss causation rule is not supported by *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988) (plurality opinion), or the efficient markets hypothesis used in *Basic*. To the contrary, that hypothesis holds that new material public information about a traded security is quickly reflected in its market price. Therefore, in any case to which the efficient markets hypothesis applies, a 10b-5 plaintiff must show the market price's prompt, negative response to disclosure of the alleged misrepresentation, and isolate that response from the market's responses to countless other pieces of information about the security. Under the Ninth Circuit's rule, however, showing the market's actual response to disclosure of the alleged misrepresentation is unnecessary, leaving no objective way to identify the price effect (if any) of the misrepresentation. The measure of damages, therefore, is dependent upon the subjective opinion of a retained expert.

Second, the Ninth Circuit's approach to loss causation is inconsistent with the plain language of the Exchange Act. The Exchange Act has always expressly limited recovery in private securities actions to investors' *actual* damages traceable to the defendants' misrepresentations. The Ninth Circuit's loss causation rule circumvents that limitation by allowing recovery for investment losses that cannot be objectively tied to the defendants' conduct. Furthermore, three provisions enacted in the Private Securities Litigation

Reform Act of 1995 ("PSLRA") confirm that Congress understands "loss causation" to mean "the *depreciation* in value of the subject security" caused by the defendant's specific misstatement or omission. 15 U.S.C. § 77*l*(b)[4]; see also *id.* § 78u-4(b)(4) (requiring securities plaintiff to prove that the defendant's misrepresentation or omission "caused the loss"); *id.* § 78u-4(e) (limiting recovery under section 10(b) to the investor's loss in the period following disclosure of "the misstatement or omission that is the basis for the action").

Third, the Ninth Circuit's approach promises serious harm to the securities industry and the economy. By exposing securities issuers and market professionals to ill-defined but substantial liability every time the markets decline, the Ninth Circuit's rule tends to create a disincentive for issuers, underwriters, and others to undertake or participate in securities transactions. Worse, the rule distorts the incentives necessary to the proper functioning of the markets by turning defendants into virtual guarantors of unprofitable investments, upsetting the markets' natural risk-reward balance and encouraging overly risky investor behavior.

ARGUMENT

Plaintiffs commonly argue that the fraud-on-the-market presumption used in *Basic* also justifies a corresponding approach to loss causation—that the presumption of *reliance* (or transaction causation) used in *Basic* should be construed as a presumption of legally compensable loss. That argument is fundamentally wrong. Not only does *Basic* not support a presumption of loss causation, but the language of the Exchange Act and the logic of *Basic* affirmatively disallow it. Transaction causation and loss causation are separate elements of private securities actions (a longstanding distinction recently made explicit by Congress), and both the

[4] Unless otherwise noted, emphases in quoted passages are added.

language of the statute and the logic of *Basic* rebut any suggestion that the presumption of reliance discharges a plaintiff's burden to plead and prove loss causation.

To the contrary, both *Basic* and the statutory language compel an approach to loss causation that turns on discrete, objectively observable market price responses to new, concrete pieces of material information. That approach, moreover, is consistent with the goals of the private securities laws, and it fosters the incentives needed to keep the financial markets healthy and strong.

I. THE NINTH CIRCUIT'S LOSS CAUSATION RULE IS INCONSISTENT WITH THIS COURT'S DECISION IN *BASIC* AND WITH THE EFFICIENT MARKETS HYPOTHESIS.

a. Securities class action plaintiffs routinely argue that the logic of *Basic* v. *Levinson*, 485 U.S. 224 (1988), supports a rule that an allegation of price inflation is a sufficient allegation of loss causation. See, *e.g.*, *In re Merrill Lynch & Co. Research Reports Secs. Litig.*, 273 F. Supp. 2d 351, 365-67 (S.D.N.Y. 2003) (rejecting that argument). The fraud-on-the-market presumption created for certain cases by *Basic*, however, only supports a presumption of reliance (also called transaction causation), not of loss causation. Any argument that *Basic* supported a presumption of loss causation was ended in 1995, when Congress amended the Exchange Act to provide expressly that a Section 10(b) "plaintiff shall have the *burden of proving* that the act or omission of the defendant alleged to violate the chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). Moreover, the logic of *Basic* itself supports a loss causation rule requiring that a plaintiff allege (and later prove) that a decline in price was caused by disclosure of previously concealed information.

Under *Basic*, most private securities litigation under Rule 10b-5 (including this case) is based on an allegation that the

securities traded in an efficient market. In a case based on such an allegation, the "premise [is] that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." 485 U.S. at 246. The guiding assumption is that an efficient market promptly and fully values all material public information (true and false) about the issuer of a traded security, and the market price on a given day reflects that composite valuation in real time. See, *e.g.*, R. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 Wm. & Mary L. Rev. 373, 374-75 (1984) (the hypothesis "posits that the price of a security reflects all publicly available information about a firm, and that prices react *almost instantaneously* and in an unbiased manner to any new information"), *cited in Basic*, 485 U.S. at 246 n.24.

The premise that securities markets react promptly to material information is central to the efficient markets hypothesis. Efficient markets by definition "are those in which information important to reasonable investors . . . is *immediately incorporated* into stock prices." *In re Burlington Coat Factory Secs. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997). Accordingly, "when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period *immediately following disclosure*, of the price of the firm's stock." *Oran* v. *Stafford*, 226 F.3d 275, 282 (3d Cir. 2000). Accord M. Mitchell & J. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 Bus. Law. 545, 558 (1994) ("the efficient markets hypothesis, supported by considerable empirical evidence, suggests that stock prices react *quickly* to the release of new information").[5]

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[5] Consequently, the efficient markets hypothesis may not necessarily apply to many debt securities, which trade much less frequently than, for example, stocks traded on the New York Stock Exchange.

Thus, in a case where the efficient markets hypothesis applies, a plaintiff cannot claim a compensable loss resulting from a misrepresentation without alleging and proving how the market promptly reacted after the alleged falsehood was revealed. The price of a security at the time of a purchase cannot by itself indicate how much value (if any) the market placed on an alleged but still unrevealed misrepresentation or omission, as opposed to other known factors about the company, much less general market or industry factors. It is only when a prior misrepresentation or omission is disclosed that the market's price can possibly give any indication as to the value of that particular piece of information. By definition, a price decline that occurred before such a disclosure cannot have been caused by that disclosure and cannot measure the value of information withheld prior to the disclosure. Such a pre-disclosure decline has to have been caused by—and reflect—other company, industry, and market factors.

Similarly, when a misrepresentation or omission is exposed, if the security's price does not promptly decline, there is no basis for alleging that the misrepresentation or omission caused a loss. The very efficient market on which the plaintiff premises his or her case has said otherwise. Indeed, when there is no negative market reaction to a disclosure, this indicates that if any inflation in the price of that security ever existed, it had other causes.

Finally, even if there is a post-disclosure decline, no loss has been caused if the investor sold the security prior to the disclosure. An "overpayment" can cause no economic injury if the buyer recoups the overage on the resale. This is common sense. If a purchaser buys a house during a "housing bubble" but sells before the bubble bursts, nobody would say that purchaser suffered a loss because he or she paid an inflated purchase price.

The Ninth Circuit's loss causation rule, though, does not require an allegation (or, later, proof) of a negative market

price reaction to the disclosure of a misrepresentation or omission, and is for that reason fundamentally inconsistent with the efficient markets hypothesis. Because the Ninth Circuit's approach focuses on the beginning of the transaction, without requiring consideration of how the transaction played out, it allows recovery where none is warranted—*e.g.*, where the plaintiff sold before the misrepresentation was exposed, or the misrepresentation was never exposed at all, or it was exposed but the market did not respond negatively.

By contrast, the majority loss causation rule (applied in the Second, Third, Seventh, and Eleventh Circuits) is the only rule consistent with an allegation of an efficient market, because it requires plaintiffs to trace their investment losses directly to specific market price reactions. In keeping with the controlling premise that efficient markets promptly and accurately value all material information, the majority rule allows recovery only when a plaintiff can establish a distinct price decline promptly following disclosure of an actionable misrepresentation or omission. The Ninth Circuit's rule imposes no such requirement and therefore is irremediably at odds with the ruling in *Basic*.

b. The fundamental unsoundness of the Ninth Circuit's approach is underscored by the difficult problems of proof it creates, which threaten unwarranted awards of indeterminate and potentially massive damages.

To show loss causation consistently with an efficient market allegation, a 10b-5 plaintiff should be required to allege and then demonstrate prompt, negative price movements caused by disclosure of the defendants' specific misrepresentations and segregate them from price movements caused by innumerable unrelated factors. If a case is properly based on the efficient markets hypothesis, and a proper allegation of a post-disclosure decline is made, the proof could be provided through a proper event study. An event study is "a statistical regression analysis that examines the

effect of an event, such as an allegedly fraudulent statement or omission, on a dependent variable, such as a company's stock price." *In re World Access, Inc. Secs. Litig.*, 310 F. Supp. 2d 1281, 1298 n.10 (N.D. Ga. 2004). A proper event study must isolate an efficient market's prompt reaction to a specific event by controlling for other events, filtering out general market "noise," and gauging the statistical significance of the market's reaction to the event in question. Thus, a proper event study is one that is projected over a short time period with clear benchmarks at the beginning and end of the interval in question. See generally Mitchell & Netter, *supra*, at 557-60.[6] When properly done, event studies can provide an objective, market-based check against speculative "expert" damages testimony. *Id.* at 584; see *World Access*, 310 F. Supp. 2d at 1298 n.10; *In re Imperial Credit Indus., Inc. Secs. Litig.*, 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003).[7]

[6] *Accord Fetch* v. *Northern Telecom Ltd. (In re Northern Telecom Ltd. Secs. Litig.)*, 116 F. Supp. 2d 446, 460 (S.D.N.Y. 2000) (holding expert testimony "fatally deficient in that [the plaintiffs' expert] did not perform an event study or similar analysis to remove the effects on stock price of market and industry information"); *In re Executive Telecard, Ltd. Secs. Litig.*, 979 F. Supp. 1021, 1025 (S.D.N.Y. 1997) ("The reliability of the Expert Witness' proposed testimony is called into question by his failure to indicate . . . whether he conducted an 'event study' to determine whether EXTL's stock price was affected by company specific factors exclusive of the challenged fraud."); *In re Oracle Secs. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) ("Use of an event study or similar analysis is necessary more accurately to isolate the influences of information specific to Oracle which defendants allegedly have distorted . . . As a result of his failure to employ such a study, the results reached by [the plaintiffs' damages expert] cannot be evaluated by standard measures of statistical significance.").

[7] Of course, given the defining premise that an efficient market reacts *promptly* to material public information, *see supra* at 8-9, the proper use of an event study presupposes a discrete, identified disclosure of material information and a relatively short "event window" (the period for measuring the market's reaction to the disclosure). Because prices in an efficient market "react quickly to the release of new information," event windows ordinarily are short, "sometimes as short as one trading day"; "long event windows may include noise and information from other events, making it difficult to isolate the impact of the relevant event." Mitchell & Netter, *supra*, at 558. "The shorter the interval over which the calculation is performed, the greater our ability to match particular pieces of news with the effects attributable to them." F. Easterbrook & D. Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 628 (1985). If, on the other hand, the plaintiff is unable to cite a specific disclosure, or relies on an unacceptably extended period of market "reaction," an event study loses its evidentiary efficacy: "the longer the potential period of adjustment, the more likely it is that noise and the presence of other information will render the calculations imprecise and perhaps unusable." D. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 Nw. U. L. Rev. 135, 177-78 (2002); *cf. Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 171 (2d Cir. 1980) (observing the difficulty of measuring a market's reaction to information in the absence of "a sharp change in market price over a short period"; a longer period or an especially "noisy" market tends to make the reaction to the alleged misrepresentation "impossible as a practical matter to isolate").

But the Ninth Circuit's approach, which ignores the market price's reaction, requires no objective check on expert speculation about damages. If a plaintiff need only allege purchase-time inflation, and need not allege (or show) any discount in the market price when the truth came out, then the one objective gauge of the plaintiff's compensable losses has been taken out of the equation. See *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 770 (2d Cir. 1994) ("The key reasons for requiring direct causation include avoiding unworkable difficulties in ascertaining what amount of the plaintiff's injury was caused by the defendant's wrongful action as opposed to other external factors, and in apportioning damages between causes."). Instead, a plaintiff will merely assert that the security was overpriced when he bought it and offer subjective opinion testimony as to what degree of inflation the jury should attribute to the defendants' alleged misrepresentations.

Without an identifiable link to discrete, prompt market reactions, there is no way objectively to separate the effect (if any) of the claimed misrepresentation from the effects of the countless other forces operating on the security's price—including both general market movements and unrelated wrongdoing (*e.g.*, fraud by another defendant). Rather than demonstrating the *actual* impact of a misrepresentation on the security's market price, the plaintiff's expert will simply state what he thinks would have been a fair price. Rather than showing how the market *did* react to the disclosure of a specific misrepresentation, the witness will opine that it *would have* reacted in a certain way under other conditions. Thus, all manner of unactionable investor losses can be stuffed into the 10b-5 damages basket.

Indeed, the Ninth Circuit's rule allows a potential recovery even where the claimed falsehood was disclosed *after* a large decline in the price of a security and where the disclosure did *not* prompt any further decline. In such a case the plaintiff's expert often gives a two-part opinion: (1) the pre-disclosure decline measures generically the market's coming to understand that the company had poor business prospects; and (2) the information disclosed *after* the actual decline also "would have" caused a similar hypothetical decline if the security had not already declined. Because the market had no negative reaction to the actual disclosure, however, there is no objective check on such junk economics. Nor can there be any objective check if a plaintiff's expert can assert causation by claiming that earlier disclosure of a relatively inconsequential fact "would have" triggered a series of events that ultimately "would have" led to other, more important disclosures. See *Robbins* v. *Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997). But the Ninth Circuit's loss causation rule invites just such expert speculation. Thus, its approach improperly allows the prospect of massive damages to be leveraged out of almost any minor misstatement. Cf. *Holmes* v. *Securities Investor Prot. Corp.*, 503 U.S. 258, 287

(1992) (Scalia, J., concurring in the judgment) ("Life is too short to pursue every human act to its most remote consequences; 'for want of a nail, a kingdom was lost' is a commentary on fate, not the statement of a major cause of action against a blacksmith.").

This kind of expert razzle-dazzle has no place in securities litigation based on the efficient markets hypothesis.[8] Yet the Ninth Circuit's loss causation rule invites it by allowing recovery that contradicts or ignores the market price's actual reaction to disclosure of the specific misrepresented fact. By contrast, the majority loss causation rule requires objectively verifiable evidence and a tight fit between disclosure of a misrepresentation and an attendant price decline. That is the correct rule, and this Court should expressly adopt it.

II. THE NINTH CIRCUIT'S LOSS CAUSATION RULE IS INCONSISTENT WITH THE STATUTORY LANGUAGE.

The requirement that a plaintiff demonstrate a prompt negative market reaction to the revelation of the defendant's alleged misconduct is not only supported by the premise of *Basic*, it is compelled by the language of the Exchange Act itself, and its companion, the Securities Act of 1933. Because the loss causation rule adopted by the Ninth Circuit is inconsistent with that language, it should be rejected.

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[8] *See, e.g.*, *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 187-91 (3d Cir. 2001) (plaintiffs cannot "gloss over" the loss causation requirement by having an expert offer some speculative "formulaic nostrum"); *West* v. *Prudential Sec., Inc.*, 282 F.3d 935, 938 (7th Cir. 2002) (requiring trial courts in 10(b) cases to "face[] and squarely decide[]" even "[t]ough questions" concerning reliability of expert theories of causation, "if necessary by holding evidentiary hearings and choosing between competing perspectives"; plaintiffs do not satisfy the causation requirement "just by hiring a competent expert"); *Grandon* v. *Merrill Lynch & Co.*, No. 95 Civ. 10742(SWK), 2003 WL 22118979, at *6 (S.D.N.Y. Sept. 11, 2003).

a. Ever since Congress enacted the Exchange Act in 1934, damages in private securities actions have been expressly limited to investors' *actual* losses. The measure of damages in 10b-5 cases is dictated by section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a), which expressly limits recovery to "actual damages," meaning the plaintiff's actual monetary loss. See *Randall* v. *Loftsgaarden*, 478 U.S. 647, 662-63 (1986); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 154-55 (1972). This limitation means that private securities actions are not a vehicle for imposing punitive damages or otherwise punishing defendants. See *Boguslavsky* v. *Kaplan*, 159 F.3d 715, 721 (2d Cir. 1998) ("punitive damages are unavailable under the 1934 Act"); *Cyrak* v. *Lemon*, 919 F.2d 320, 326 (5th Cir. 1990) ("Punitive damages are not recoverable in a 10b-5 action."); *Pelletier* v. *Stuart-James Co.*, 863 F.2d 1550, 1557 (11th Cir. 1989) ("'Actual damages' has been interpreted to mean some form of economic loss and does not include punitive damages."). Congress reinforced this in 1995 by enacting a provision in the PSLRA amending RICO to provide that "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of [RICO]." Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 107, 109 Stat. 737, 758 (amending 18 U.S.C. § 1964(c)). This exclusion makes clear that private securities plaintiffs are not eligible for RICO's treble damages.

The "actual damages" limitation is consistent with the majority loss causation rule and inconsistent with the Ninth Circuit's purchase-time inflation rule. Under the Ninth Circuit's rule, damages are divorced from investors' actual losses for two reasons. First, defendants can be held potentially liable not only to those investors who can prove a price decline caused by the defendants' conduct, but also to investors who did not lose money as a result of the defendants' conduct, for example, because they sold before the conduct was exposed and the price dropped. Thus, a

securities issuer may be held liable for many times the losses actually occasioned by its misstatement or omission—that is, for what are really punitive not "actual" damages. Second, as discussed above, damages that are not linked to actual, prompt price changes in the market, but instead to dueling expert witnesses' subjective opinions, bear no relationship to a plaintiff's actual losses and, moreover, are uncertain and potentially enormous.

The majority loss causation rule, by contrast, is fully consistent with the statute's "actual damages" requirement. That rule makes damages available only to plaintiffs who can show that the losses they suffered were caused by specific misrepresentations made by the defendant, as demonstrated by a prompt and distinct market price adjustment upon disclosure of the specific, correct information. When price declines have other causes, such as publicly available information about other, nonfraudulent facts about the company, the industry, or the general market, such declines are not "actual damages" caused by the defendant.

b. Any doubt as to whether the Ninth Circuit's loss causation rule conflicts with the Exchange Act was resolved by the PSLRA. In the PSLRA, Congress codified the loss causation requirement by providing that in a private section 10(b) case, the "plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused *the loss* for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). This language simply does not allow, for example, a plaintiff to measure damages by a price decline that occurred *before* any misrepresentation was disclosed to the market. A disclosure cannot have caused a decline that already occurred.

Moreover, in another provision of the federal securities statutes, Congress defined the "loss" in loss causation as a decline, not inflation. Section 12 of the Securities Act of 1933 (15 U.S.C. § 77*l*) creates an express cause of action in certain circumstances. Section 105 of the PSLRA defines

"Loss Causation" in a section 12(a)(2) civil action. See Pub. L. No. 104-67, § 105, 109 Stat. at 757; 15 U.S.C. § 77*l*(b). Section 105 defines the actionable loss as "*the depreciation in value* of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein." *Id.*; see also S. Rep. No. 104-98, at 7 (1995) (describing loss causation under 15 U.S.C. § 78u-4(B)(4) as "the loss in the value of their stock . . . caused by the Section 10(b) violation and not by other factors"). Plainly, "depreciation in value" means decline in price, not inflation. Section 105 is highly significant because this Court has held that it would be "anomalous to impute to Congress an intention in effect to expand [aspects of] 10b-5 actions beyond the bounds delineated for comparable express causes of action." See *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180 (1994).

Congress also implicitly endorsed the majority loss causation rule requiring a corrective disclosure and accompanying price drop in another PSLRA provision. The statute's "lookback" provision (section 21D(e) of the Exchange Act) limits a securities plaintiff's damages to "the difference between the purchase or sale price . . . and the mean trading price of that security during the 90-day period *beginning* on the date on which *the information correcting the misstatement or omission that is the basis for the action is disseminated to the market*." 15 U.S.C. § 78u-4(e).

This provision is significant not only because it reflects Congress's concern with "windfall" damages for price movements "unrelated to the alleged fraud," S. Rep. No. 104-98, at 20, but also because it uses the price of the security "*beginning*" with "*information correcting the misstatement or omission*" to measure a plaintiff's damages. 15 U.S.C. § 78u-4(e). The 90-day window is pegged to the date of disclosure because Congress expressly recognized that an investor's

damages are limited by "the difference between the price he or she paid for the security and the price of the security on *the date the corrective information is disseminated to the market*." S. Rep. No. 104-98, at 19-20.

The Ninth Circuit's loss causation rule is completely at odds with this damages-limitation provision because it ignores the market's reaction to "the information correcting the misstatement or omission." Indeed, it is not clear how the PSLRA's damages limitation could even be applied under the Ninth Circuit's rule, since that rule does not require the plaintiff to allege or prove the effect on the market price of a corrective disclosure. In short, a loss causation rule that merely requires price inflation at the time of purchase is flatly inconsistent with Congress's expressed intent in enacting the Exchange Act, as modified by the PSLRA.[9]

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[9] As we have shown, Congress has itself defined loss causation as requiring that a specific misrepresentation cause a specific price decline. Accordingly, there is no reason to look to the common law to fill any statutory gap. Nevertheless, under established tort principles that exist apart from the Exchange Act, there is no recovery when a price decline is caused by other factors. *See, e.g.*, W. P. Keeton et al., *Prosser and Keeton on the Law of Torts* § 110, at 767 (5th ed. 1984) ("if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, or insolvency of the corporation brought about by business conditions or other factors in no way relate[d] to the representations will not afford any basis for recovery"). The *Restatement (Second) of Torts* provides a useful illustration:

> A, seeking to sell to B the municipal bonds of C County, fraudulently tells B that the county has received full payment for the bond issue. B purchases the bonds in reliance upon this statement. Subsequently the county is paid in full, but the bonds are held void by the supreme court of the state on the ground that a court had no jurisdiction to issue certain orders with respect to them. As a result B suffers pecuniary loss. A is not liable to B for the loss.

Restatement (Second) of Torts § 548A cmt. b, illus. 1 (1977). In this example, the plaintiff will not recover because his loss on the bond investment was not caused by the defendant's misrepresentation—*even though* the plaintiff's purchase price was inflated because of the misrepresentation about the county's receipt of full payment—because the

III. THE NINTH CIRCUIT'S LOSS CAUSATION RULE WOULD HAVE SERIOUS HARMFUL EFFECTS.

The Ninth Circuit's misguided loss causation rule, if allowed to stand, will seriously damage the securities industry and securities markets in three significant ways.

First, the Ninth Circuit's rule will tend to discourage market participants (including securities issuers, investment firms, lawyers, and accountants) from undertaking or participating in economically beneficial market transactions. As shown above, the Ninth Circuit's rule permits recovery by investors with no actual losses, and invites gross over-recovery even in cases with some merit. The rule thus exposes market participants to potentially massive liability for losses untied to their conduct.

The inevitable consequence is a disincentive for those market participants to undertake or participate in securities transactions. Investment banks, for example, will inevitably tighten their purse strings and decline certain otherwise attractive transactions if faced with the prospect of having to underwrite a market slump. The resulting suppression of a robust securities market harms the entire economy. See H.R. Rep. No. 104-50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets" and "businesses suffer as auditors and directors decline engagements and board positions."); cf. *Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) ("No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation.").

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investment had a different, unrelated cause of loss (*i.e.*, with or without full payment, the bonds were void). Yet the Ninth Circuit's approach would allow recovery in such circumstances based solely on price inflation at the time of purchase.

Second, the Ninth Circuit's rule interferes with the proper functioning of modern financial markets. Every investor has a panoply of investment options, ranging from federally insured certificates of deposit ("CDs") that have essentially zero default risk but a limited return, to Dow 30 stocks that traditionally offer moderate risk and a solid return, to stock in smaller and less well-established companies that traditionally have substantial risk but offer higher potential returns. With respect to federally insured CDs, Congress has chosen to socialize investment losses by implementing an insurance system administered by the FDIC and other agencies. Returns are modest but assured, and insured depositors have essentially no incentive to determine which insured banks are likely to become insolvent.[10]

In contrast, with respect to the stock and bond markets, Congress has chosen not to create investor insurance. See *Carlton* v. *Franklin*, 911 F.2d 721 (4th Cir. 1990) (per curiam) (table), *available at* 1990 WL 116788, at *4 ("The reasoning behind the requirement of loss causation is that, otherwise, the federal securities laws would establish an

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[10] As Federal Reserve Board Chairman Alan Greenspan recently testified:

> The benefits of deposit insurance, as significant as they are, have not come without a cost. The very process that has ended deposit runs has made insured depositors largely indifferent to the risks taken by their depository institutions, just as it did with depositors in the 1980s with regard to insolvent, risky thrift institutions. The result has been a weakening of the market discipline that insured depositors would otherwise have imposed on institutions. Relieved of that discipline, depositories naturally feel less cautious about taking on more risk than they would otherwise assume. No other type of private financial institution is able to attract funds from the public without regard to the risks it takes with its creditors' resources. This incentive to take excessive risks at the expense of the insurer, and potentially the taxpayer, is the so-called moral hazard problem of deposit insurance.

Alan Greenspan, Chairman, Fed. Reserve Bd., Testimony on Deposit Ins. Before the Senate Comm. on Banking, Housing, and Urban Affairs (Feb. 26, 2003), *available at* http://www.federalreserve.gov/boarddocs/testmony/2003/20030226/default.htm.

insurance program for every security purchased in reliance on a misstatement, even if the misstatement bears no relation to the reason for the decline in the security's value."); *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) ("Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission."), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983). As a result, investors have every incentive to investigate and identify which potential high-return investments are sound and which are not. Thus, unlike in a system with investor insurance, the market dynamics of risk and reward give investors a full incentive to direct capital to uses where the potential rewards genuinely justify the potential risks.

The Ninth Circuit's loss causation rule skews this risk-reward dynamic by changing the market dynamics for higher-risk investments. By definition, insurance against the negative consequences of a risky activity encourages the insured to engage in that activity. See *May Dep't Stores Co.* v. *Federal Ins. Co.*, 305 F.3d 597, 601 (7th Cir. 2002) (noting "the incentive that insurance can give an insured to increase the risky behavior covered by the insurance"). By allowing 10b-5 actions to serve as a vehicle for recovery of investment losses that are *not* attributable to a securities defendant's behavior, the Ninth Circuit's rule would give investors greater incentive to invest in riskier ventures. If a higher-risk company pays off, the investors keep the profits; if it fails, the defendants bear the burden of much of the loss. *Bastian*, 892 F.2d at 685 ("Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities"). This would short-circuit the beneficent risk-reward dynamic of the securities markets. At a minimum, whether to change the existing securities system to require investor insurance is a matter for Congress, not the courts.

Third, the Ninth Circuit's rule harms shareholders by fostering arbitrary settlements and awards that fail to align litigation recoveries with investors' interests. In the real-world context of private securities litigation, "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general"; in 10b-5 cases "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-40 (1975).

> This uncertainty and excessive litigation can have ripple effects. For example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and *in turn incurred by the company's investors*, the intended beneficiaries of the statute.

Central Bank, 511 U.S. at 189.

Congress recognized the same phenomenon, and designed the PSLRA with it in mind. "If a defendant cannot win an early dismissal of the case, the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial." S. Rep. No. 104-98, at 7 (1995) (internal quotation marks omitted). That is, large settlements are almost assured to a 10b-5 plaintiff class that survives dispositive motions, and the settlement usually has little to do with the merits of the lawsuit.

At least one major empirical study bears this out, concluding that "there appears to be *no appreciable risk* of non-recovery" in securities class actions, because "virtually all cases are settled," regardless of their legal merits. J. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 578 (1991).[11] For various familiar reasons, including risk aversion, asymmetric litigation costs, and the ubiquity of D&O insurance, the pressure to settle a securities suit—even a meritless one—is as a practical matter all but irresistible. *Id.* at 521-55. Accordingly, "when there has been a sharp decline in the market price of a company's stock, the mere filing of a complaint appears to be a ticket to a guaranteed and substantial recovery. *Getting the claim into the legal system*, without more, sets in motion forces that ultimately compel a multi-million dollar payment." *Id.* at 569. Accord *Hevesi* v. *Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004) ("numerous courts and scholars have warned that settlements in large [securities] class actions can be divorced from the parties' underlying legal positions"); *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001) (discussing the "inordinate or hydraulic pressure on [securities fraud] defendants to settle, avoiding the risk, however small, of potentially ruinous liability").

The Ninth Circuit's loss causation rule invites such settlements because it fails to eliminate the claims of uninjured investors at the pleading stage and affords no

[11] As the Second Circuit has observed,

> [a]necdotal evidence tends to confirm [Alexander's] conclusion. Indeed, [Melvyn I.] Weiss and his partner William S. Lerach of the Milberg firm have stated that losses in these cases are "few and far between," and that they achieve "a significant settlement although not always a big legal fee, in 90% of the cases [they] file."

Goldberger v. *Integrated Res., Inc.*, 209 F.3d 43, 52 (2d Cir. 2000) (quoting *In re Quantum Health Res., Inc. Secs. Litig.*, 962 F. Supp. 1254, 1258 (C.D. Cal. 1997)).

objective check on causation and damages. Given the high strike value of 10b-5 class suits, the practical result is a wealth transfer from a company's current securities holders to a group of investors who bought during the class period—many of them no longer investors in the company—and their lawyers.

By contrast, the majority loss causation rule, which turns on observable market movements, supplies a ready means for weeding out unmeritorious claims through motions practice. For claims that can survive a motion to dismiss and a motion for summary judgment, settlement discussions can be based on objective events and established methodologies such as proper event studies, rather than on wholly subjective "expert" speculation. For this reason, in addition to its consistency with Congressional policy and legal precedent, the majority rule is the correct one.[12]

[12] Any concern about defendants' escaping the consequences of their wrongdoing is entirely misplaced. Not only does the majority loss-causation rule allow full recovery of actual losses, but it in no way detracts from federal and state administrative and criminal remedies that are otherwise available against wrongdoers even when there is no financial loss. Recent history shows these are powerful tools.

CONCLUSION

For the foregoing reasons, the Ninth Circuit's ruling should be reversed.

Respectfully submitted,

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